TESTIMONY OF

MARK J. GRIFFIN
Director, Utah Securities Division

PRESIDENT
NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

before the
SUBCOMMITTEE ON FINANCE AND HAZARDOUS MATERIALS

of the
COMMITTEE ON COMMERCE

H.R. 1053, the "Common Cents Stock Pricing Act of 1997"

April 16, 1997

SUMMARY OF TESTIMONY
for
MARK J. GRIFFIN, Director of the Utah Division of Securities

PRESIDENT

NORTH AMERICAN SECURITIES ADMINISTRATORS' ASSOCIATION, INC.

NASAA is the oldest international organization devoted to investor protection and is the collective voice of 50 state securities regulators and those provincial regions of Canada, Mexico, the District of Columbia and Puerto Rico.

NASAA supports efforts to change stock price quotations from dollars and fractions to dollars and cents for equity securities transactions. NASAA's interest in the well-being of small investors is what led to our position on H.R. 1053.

There is intrinsic value to simplicity when it comes to communicating with investors. A common-sense argument for decimalization is that it would simply make the markets easier for investors to understand. Citizens should not be forced to use either their dictionaries or calculators to determine the profit or losses on the stocks they have in their portfolios.

The challenge of what to do about financial illiteracy will be made less daunting if H.R. 1053 becomes law. The basic pricing of our stock markets will be understandable to anyone with an elementary school education. Individual investors will be better able to ascertain their purchasing power and how much stock they can afford to own.

Decimal pricing would make the markets fairer for small investors who would be on a level playing ground with market professionals who trade on venues like Instinet and Telemark, which are not subject to the 1/8th rule.

In its 1994 Market 2000 report, the SEC's Division of Market Regulation states that "decimal pricing is preferable and may be inevitable some point in the future." After three years, the time for the change is now.

Chairman Oxley and Members of the Subcommittee:

My name is Mark Griffin, Director of the Utah Division of Securities. I have been a state securities regulator for nearly 13 years and have served in two states as director of their securities agencies. I am also President of the North American Securities Administrators Association ("NASAA"), in which capacity I am testifying today. I am accompanied by Neal Sullivan, Executive Director of NASAA, and former Vice President of the Boston Stock Exchange, and we will both be available to answer any questions you may have.

Mr. Chairman, I commend you and your colleagues for holding these hearings to draw attention to an important consumer issue: decimalized pricing in our financial markets. I realize this is not a subject that your constituents raise at the local town hall meeting or which you come across in the congressional mailbag, but Mr. Chairman, the good that will come of these hearings will ultimately benefit the middle class of our society who are the future of our financial markets.

NASAA is the oldest international organization devoted to investor protection. We are the collective voice of 50 state securities regulators and those provincial regions of Canada, Mexico, the District of Columbia and Puerto Rico. State securities agencies are the local "cops on the beat;" our mission is to protect the small investor, and it is a mission, which if performed effectively, promotes capital formation. As you know, if our markets are not safe and fair, they will not be adequately capitalized. Attached to my testimony are letters of support for your legislation from securities commissioners of four states.

Our focus is local; our cases somewhat smaller, we have our eyes on our local communities, assuring that no matter where the investor resides or how large his or her account, that investor is treated with equity and fairness. Consequently, most of the investors we look after are smaller, retail investors; our friends and neighbors, if you will.

NASAA's interest in the well-being of these smaller investors is what brings me before you today.

Mr. Chairman, more than ever before, our markets are enjoying broader participation of smaller, and relatively new investors, today we have over 60 million direct market participants. There are many reasons for this. Certainly, one of the most compelling is the realization that some adjustments to social security and other social programs that supplement retirement are highly probable. Today, it would be unreasonable for the average man or woman to expect to work for one employer for 30 plus years then receive a corporate pension.

This situation is growing more compelling every day; according to the Securities and Exchange Commission ("the SEC"), more American households are investing in the markets than ever before. Average daily share volume on the New York Stock Exchange has risen from 178 million in 1991 to over 410 million shares in 1996, over a 130% increase. It is not only the Big Board, the regional Boston Stock Exchange has experienced similar growth from 3.9 million average daily shares to 6.2 million in 1996, a 63% increase. The National Association of Securities Dealers Automated Quotation system ("NASDAQ") increase from 163.3 million to over 543 million during the same period of time reflects a rise of 232 percent.

The record $3.5 trillion in mutual funds exceeds U.S. commercial bank deposits, and in some respects these assets under management in the mutual fund industry reflect the reluctance of smaller investors to feel competent in fending for themselves, trading individual securities, and managing their own investments. That observation is not to disparage in any way the mutual fund industry, but simply to point out that it is symptomatic of a general lack of financial literacy among these new investors that may be contributing to the phenomenal growth of these funds. If we open today's financial pages we'll see that the funds price in a decimalized format.

So, today's stock market is becoming the home of middle America, gone forever are the days of a market catering to sophisticated, wealthy individuals. We believe all of these developments are good, as long as markets evolve to account for these new participants.

A common-sense argument for decimalization is that it would simply make the markets easier for investors to understand. The SEC recently promulgated a "plain English" rule proposal that will make disclosure documents easier to read by requiring the use of plain English on the cover page, summary and risk factors sections of prospectuses. We concur with the Investment Company Institute's comment letter to the SEC which said, "We agree that investors must be able to understand disclosure to use it. The mutual fund industry benefits when investors are well-informed."

There is intrinsic value to simplicity when it comes to communicating with investors. Citizens should not be forced to use either their dictionaries or calculators to determine the profit or losses on the stocks they have in their portfolios.

As we at the state level have watched these new participants coming to our markets, we see that one of our greatest challenges is financial illiteracy. A recent survey by the Princeton Research Group for the non-profit Investor Protection Trust which involved interviews with 1,001 investors nationwide, found
only 18 percent of investors surveyed are truly literate about financial matters specifically related to investing.   These were investors who correctly answered seven or eight questions on the eight-point investor knowledge index used in the survey. Fifty percent scored four to six points and 32 percent scored zero to three points.

These are not encouraging findings for a society that is moving increasingly to a "self-serve" approach to personal finance. And every day in this country small investors report to state securities commissioners losses that might otherwise have been avoided by a more thorough education and understanding in financial matters.

The challenge of what to do about financial illiteracy will be made less daunting if your bill becomes law. Under its provisions, the basic pricing of our stock markets will be understandable to anyone with an elementary school education. Individual investors will be better able to ascertain their purchasing power and how much stock they can afford to own. There may be substantial benefits to the financial services industry not yet discussed.

Since some of our investor complaints originate from a lack of understanding and agreement between broker and investor, simple, easy-to-understand decimal pricing may well result in fewer complaints and misunderstandings. The time and expense that is currently expended in explaining the antiquated system of bidding in fractions, and in sorting out the confusion that occasionally results from it, might be put to better competitive uses.

As I am sure others have testified, it is widely recognized that the fractionalized system originated from trade in the Spanish dollar during the 1700s, when eighths or “bits” as they were called, were employed by market traders. While the origin of the current system may be quaint, it is clearly antiquated in a world of dollars and cents, and where all other major world markets trade in decimals. One would have to suspect a reason for this failure to update, and there is a reason.

The use of an eighth guarantees a minimum bid/ask spread of 12.5 cents, meaning higher compensation for traders where market or competitive forces might narrow that margin.

Leaving aside the question of whether that system makes sense in today’s world economy, the system creates a clear disadvantage for small investors. Why? Well, because larger, more sophisticated investors have access to trading venues like Instinet and Telemark, which are not subject to the 1/8th rule. These larger investors demanded smaller incremental bids and have achieved spreads amounting to only a few cents.

On a related matter, last week the Wall Street Journal ran a story describing problems associated with “off board” trades. [1] Off board trading occurs when huge blocks of U.S.-listed stock change hands in foreign markets in transactions that seldom appear on trading records of the stock exchanges. Some suggest such trades detract from the stock market’s transparency and the ability of investors to see all trades, and certain officials would like to bring that trading back to stock exchanges to correct those inadequacies.

I hope you agree with me that all investors in the domestic securities markets should have access to the same price. Similarly, as evidenced by recent rulemaking, the Securities and Exchange Commission has reaffirmed its belief that all investors should have access to the same price. The Commission recently adopted rules to facilitate better order execution by allowing all investors, both retail and institutional to better compete completely on the basis of price.

As Chairman Levitt noted “[the Commission’s] goal is simple: to let competition do the work to foster increased fairness, efficiency and best execution.” NASAA believes that, in the debate over decimalization, the markets’ demand for greater transparency and increased competition should be a shared goal. Decimalization realizes that goal.

One area of concern for state regulators over the past several years is the ever growing practice of payment for order flow. Payment for order flow refers to the payment of cash or rebates from exchange fees that flow back from the dealer, specialist or exchange to the party placing the order. This rebate is used as an incentive for brokers to route their aggregated small orders through certain dealers or specialists, and in the case of exchanges rebating fees, to increase trading volume. Payment for order flow has been criticized as potential interference with the customer receiving the best price available for his or her order. Although these arrangements often guarantee the order receives the national best bid or best offer, there is little chance for price improvement by exposing it to the market.

This practice is possible because even after paying one or two cents per share for both sides of the transaction (a total of four cents), market makers make a profit of eight and a half cents. A criticism of this practice is that it benefits broker-dealers rather than their customers and few customers are even aware that the system exists. If an auto body repair shop rebated some of the customers payment to the insurance company as an incentive to attract business, consumers would be outraged. Investors should be similarly outraged.

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[1] Ip, Greg, “More Big Stock Sales Are Handled ‘Off Board’ ”, *Wall Street Journal*, April 9, 1997.

The practice of payment for order flow where several parties except for the investor making the order receive some portion of the spread can be minimized in a market priced in decimals. All the information points to a reduction in spreads in a market that trades in decimals. The lower the spread, there is decreased opportunity for a specialist or dealer to offer this "kickback."

The dealer or specialist can only decrease its margin on a per share basis so far. Eventually the payment for order flow will have to end or the dealer will be losing money on the trade. Some may argue that the end of payment for order flow will
increase the cost of trades for individuals investors. If this should happen, at the very least an individual investor will know exactly what his or her execution cost is without part of the price being buried in the spread.

Some have suggested that we are not quite ready for this legislation. They point to the conversion costs of switching systems; they suggest that trading in sixteenths also narrows the spread and accomplishes the same goal; they argue that liquidity for smaller, thinly traded companies may dry up if minimum 12.5 cent spreads are not guaranteed. But most of these arguments are specious.

According to the Securities Industry Association's own figures, the pre-tax net income for securities firms reached $11.27 billion in 1996, a 31 percent increase over 1993's record $8.6 billion. Average daily volume on each of the three major exchanges set records for 1996, with an average increase of 22 percent over 1995's volume. I agree there will be a cost associated with converting to decimal trading. But, clearly the time to assume this one-time cost is while our markets are doing well.

We applaud the American Stock Exchange and the National Association of Securities Dealers Automated Quotation System for moving toward smaller trading increments. This is a step in the right direction and we hope they will take the next step to bring decimals to stock prices. Decimalized trading offers truer market pricing.

First, it is our experience that the spreads in thinly traded stocks rarely are as small as 1/8th. If we were to look at a trading screen this morning it would show many $2 and $3 stocks trading at 3/4 to 7/8. Let us be clear that the greatest benefit will be realized on high volume stocks, not on the tiny stocks that often trade in spreads higher than 50 cents.

Second, even the strongest opponents of this bill will have to admit that the cost of system conversion will eventually have to be encountered to meet the demands of global competition from other markets. In that sense it is a question of timing and the only difference is the economic benefit conferred on some market professionals during the period of delayed implementation. Besides, lengthy delays could result in a mandated conversion during a period less financially prosperous than today's markets.

Third, if the marketplace is willing to accept practices such as payment for order flow and artificial pricing increments, eventually investors will come to realize the detrimental impact borne by them and demand a move to decimalization. That is why I commend you for your leadership in bringing this issue to the attention of the investing public. In short, decimalization is just one more reasonable move towards modernization, which some market participants will resist, but which, when implemented, will improve markets and trading.

NASAA believes that a country trading in fractions, alone in a global market, cannot easily compete. Technology has been enthusiastically embraced that can facilitate the marketing of product. We believe it should be just as warmly received in the improvement of prices. NASAA does not suggest that we have the answers to what systems are the most efficient and cost effective. We do not, at this time, have a view on the pricing increments but we do believe the more efficient, market driven pricing offered by decimals is needed.

In its 1994 Market 2000 report, the SEC's Division of Market Regulation states that "decimal pricing is preferable and may be inevitable some point in the future." Mr. Chairman, I agree with you and your colleagues, it is inevitable, and, after three years, the time for the change is now.